NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2005 through the Fourth Quarter of 2008

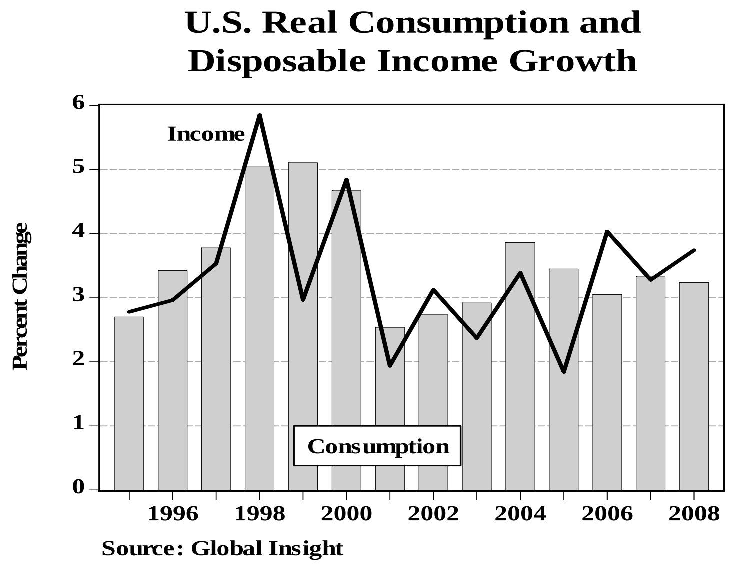
Like it did most of the news this fall, Hurricane Katrina dominates this *Forecast*. The national economic forecast herein was released in early September 2005, during the brief lull between Hurricanes Katrina and Rita. As a result, the forecast includes the estimated economic impacts of Hurricane Katrina, but does not include the impacts of Hurricane Rita. When evaluating the reasonableness of these estimates it is important to remember they were made soon after Hurricane Rita struck Louisiana and Mississippi. These impacts are being refined as new data become available. In general, it appears the negative impacts from the storm may have been overestimated. For example, immediately after the storm, it was estimated 8,000 to 10,000 lives were lost. Thankfully, it appears the total loss of lives was much lower.

National employment has also fared better after the storm than had been anticipated. Global Insight's economists assumed Hurricane Katrina's employment toll would be 270,000 jobs in September. Global Insight also assumed the Boeing machinist strike would reduce employment by an additional 18,000 jobs. However, part of this decline would be offset by the projected 170,000 jobs created elsewhere in the economy, so the net effect would be 120,000 jobs lost in September. The U.S. Department of Labor estimates the net job loss for the month was just 35,000. Part of this net job impact reflects the nation's strong employment situation. Specifically, the August gain was raised to 211,000 in September 2005. The Department of Labor also increased its July nonfarm employment estimate to 277,000. The labor market's strength this summer is also visible in the falling U.S. civilian unemployment rate that sank to a recovery low of 4.9%, its lowest level in four years. The unemployment rate rose marginally to 5.1% in September. The unemployment rate is expected to stay near this level for the remainder of this year, then, boosted by rebuilding efforts, gradually decline.

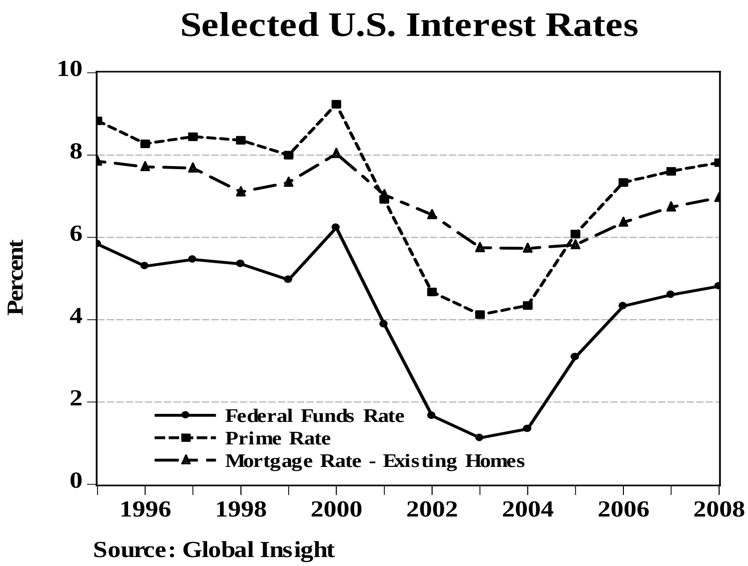
Hurricane Katrina has raised the short-term inflation rate outlook, which should come as no surprise to anyone who has purchased gasoline recently. The U.S. average price of unleaded gasoline leaped well over $3 per gallon soon after Hurricane Katrina made landfall. The average gasoline price has receded since then, but still remains well above its year-ago price of $2 per gallon. Natural gas may climb to 50% above last winter's price. High-energy prices translate into a nearly 25% jump in the energy commodity component of the consumer price index in 2005. Eventually, energy prices should retreat, but the decline will be gradual and a return to 2004 levels is not expected. The nation's central bank policymakers believe inflation is a greater risk to the economy than Hurricane Katrina's aftermath. As a result, the Federal Reserve continued its policy of raising its federal funds rate in 25-basis point increments to 3.75% on September 20, 2005. Katrina will have a bigger impact on fiscal policy than on monetary policy. Before the hurricane, the federal deficit was expected to shrink in fiscal year 2006 (October 1, 2005 to September 30, 2006). However, disaster relief will increase federal outlays, which is expected to boost the federal deficit to $343 billion in fiscal year 2006.

Hurricane Katrina has slowed the economy, but it has not sent it reeling. At the aggregate level, the storm has shaved expected real output growth below previous estimates through the year's end. The storm's impact could have been worse, but the economy was growing at a strong clip, and this momentum should keep it from slipping into a recession. Down the road, the economy will actually benefit from efforts to rebuild the damage from one of the nation's worst natural disasters.

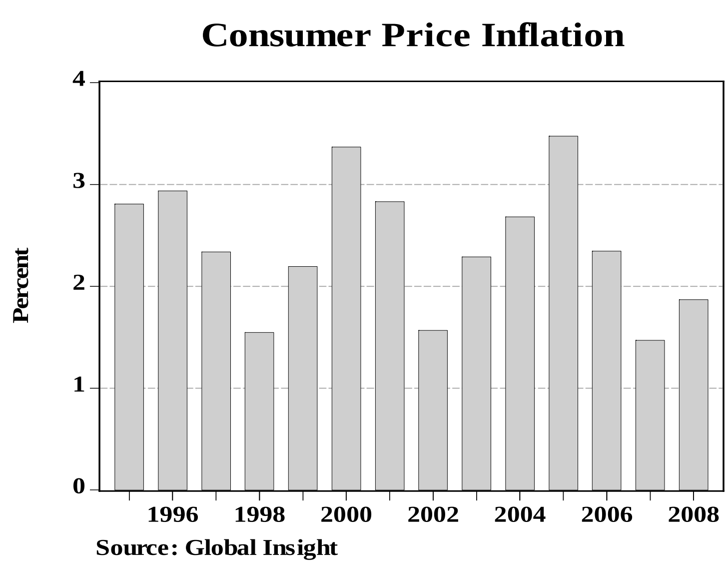
SELECTED NATIONAL ECONOMIC INDICATORS



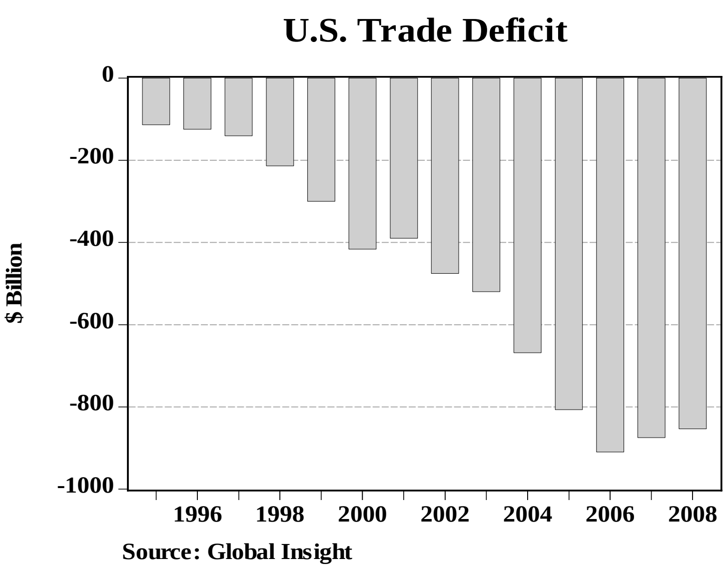
Consumer Spending: It is tempting to blame Hurricane Katrina for the real consumer spending slowdown in this year's last quarter, but the storm is not the origin of the expected lull. In fact, economists were forecasting the consumer retrenchment long before Katrina appeared on the radar. For example, as recently as August 2005, Global Insight predicted annualized real consumer spending growth would slip below 2% in this year's fourth quarter after advancing at whopping 4% in the previous quarter. The reason for this spending seesaw reflects carmakers' success at luring customers back into automobile showrooms. Thanks to "employee discount pricing" programs by major manufacturers to work off excess inventories, estimated annual light vehicle sales hit nearly 18 million units in the third quarter of 2005, which boosted annualized spending on motor vehicles and parts 28.8% in that quarter. Annual light vehicle sales are expected to swing by about two million units to 15.9 million units in the fourth quarter of 2005, as manufacturers end their latest sales programs. More correctly, Hurricane Katrina is not the origin of the consumer spending slowdown, but it does accentuate it. The storm's impact can be seen by comparing the August 2005 and September 2005 forecasts. Again, real consumer spending was previously expected to grow at about a 4% annual pace in the third quarter of 2005 and by less than 2% in the following quarter in the August 2005 forecast. In the September 2005 forecast, real consumer spending advances just under 4% in the third quarter of this year and by less than 1% in the fourth quarter. Interestingly, this slowdown is short lived, and by the second quarter of 2006, real consumer spending actually grows faster than had been forecast in August 2005. Thus, Hurricane Katrina's impact on overall consumer spending should be relatively slight. The storm's biggest impact will be on energy prices. Although the energy price shock from Katrina should be temporary, it is layered upon a three-year escalation in petroleum and natural gas prices and a tight supply situation. The recent surge in gasoline prices cost U.S. households an average of $60 per month, or 0.9% of disposable income. The likely responses to this increase include less spending on discretionary products, fewer shopping trips, and the choice of clustered and super stores over stand-alone outlets to save fuel. Gasoline prices are expected to retreat to $2.50 per gallon by year's end, but this will not mark the end to consumers' energy price woes. Natural gas prices are expected to remain elevated through the winter, which should push home heating bills up 30% above last winter. The average household energy bill (including gasoline, fuel oil, natural gas, and electricity) will reach an annual rate of $4,900 in the fourth quarter of 2005, which is 22% above its year-ago level. Looked at another way, the share of disposable income spent on energy will climb to 6%—its highest level in two decades. Energy prices are expected to retreat over the next three years, so energy costs will take a smaller bite out of household budgets. While the impacts of Hurricane Katrina shape short-term spending, longer term spending will be dominated by income. Having exhausted their savings and run up their credit cards, American consumers will be forced to live within their means. In other words, spending growth should be limited by income growth. Over the forecast period real consumer spending is forecast to rise 3.4% this year, 3.0% next year, 3.3% in 2007, and 3.2% in 2008. Real disposable income is anticipated to increase 1.8% in 2005, 4.0% in 2006, 3.3% in 2007, and 3.7% in 2008.



Financial Markets: Federal Reserve policymakers and Global Insight economists both agree on the general prognosis for the economy after Hurricane Katrina, but their policy prescriptions for the economy's health differ. Both groups believe the economy will return to prosperity after taking a short hit from the storm. To quote the Federal Open Market Committee (FOMC), "While these unfortunate developments have increased the uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat." This explains the committee's most recent action. On September 20, 2005 the FOMC raised its federal funds rate target by 25 basis points from 3.5% to 3.75%. This move came as a surprise to some economists. Global Insight believed the central bank would postpone any rate hikes until it could evaluate the damage from Katrina. To reflect this policy, Global Insight assumed the FOMC would not raise the federal funds rate during its September 20, 2005 and November 1, 2005 meetings, and this has been built in to the current forecast. Obviously, the FOMC is comfortable with continuing its policy of measured increases. This action reflects the FOMC's belief that Hurricane Katrina's impact on the economy will be modest, but the committee has concerns about inflation. These fears are founded in the recent jump in energy prices and tight labor market that could start to put upward pressure on wages. In addition, rebuilding efforts could increase the demand for construction materials, further boosting prices for items that are already in tight supply. If the FOMC sticks to this policy, the federal funds rate will hit 4.5% sooner than has been anticipated in this forecast. The federal funds rate is expected to rise gradually to 5% by the end of 2008. The outlooks for several key interest rates are included in the accompanying chart.



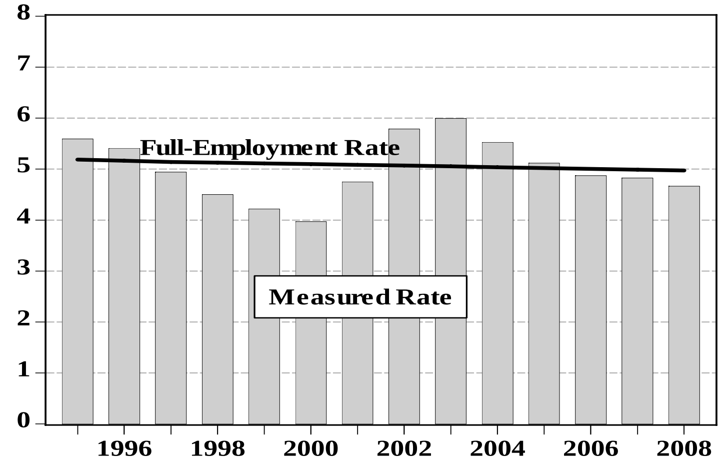
Inflation: Hurricane Katrina has had a two-fold impact on the inflation forecast. It has both raised the short-term inflation rate forecast and widened the uncertainty of the inflation outlook. These impacts are based on changes that have already taken place. Examples are not hard to find. Natural gas prices were $5.30/mmBTU last year, but are now above $12.00/mmBTU. One year ago crude oil prices were $30 per barrel, which is much lower than its current $65 to $70 per barrel range. U.S. gasoline prices are up about 50% since last year, from $2 per gallon to around $3 per gallon. The increased uncertainty stems not only from the magnitude of these price increases, but also how quickly prices have risen. For example, the price of oil jumped by $4 to $70 per barrel in one day as Hurricane Rita brewed in the Gulf of Mexico. The U.S. average price of unleaded gasoline leapt to well over $3 per gallon soon after Hurricane Katrina made landfall. The spot price of natural gas jumped 30% in just two days—and to more than 135% above its year-earlier level. This forecast assumes energy prices will soon peak. There are two facets of the energy price forecast worth highlighting. The energy price retreat will be gradual and energy prices are not expected to return to their year-ago levels. This is because even after the impacts of Hurricane Katrina recede, other factors will keep prices higher than in the past. These factors include continuing problems in the Middle East, heavy energy purchases by China, and limited domestic refining capacity. Higher energy prices translate into a nearly 25% jump in the energy commodity component of the consumer price index in 2005. After this year, the energy commodity index is projected to increase 1.7% in 2006, 7.9% in 2007, and 3.9% in 2008. Overall consumer inflation will be much milder. As measured the by the U.S. consumer price index, prices should jump 3.5% in 2005, increase 2.3% in 2006, grow 1.5% in 2007 and rise 1.9% in 2008. The core inflation rate (all items less energy and food) is forecast to rise 2.2% this year and 2.4% in each of the remaining years of the forecast.



International: The outlook for global economic growth is generally positive, but it is vulnerable to risks from higher oil prices and the still-imbalanced nature of the expansion. American domestic demand and China's robust production growth remain the key engines of the global expansion. These twin drivers should help the world economy advance 3.2% annually over the forecast period. It should be pointed out, however, that this road to prosperity contains hazards. High oil prices remain an obstacle to the expansion. Until Katrina, rising energy prices had largely reflected the demand emanating from the robust U.S. and Chinese economies. The after effects of Hurricane Katrina serve as a reminder of how vulnerable the world's economy is to a severe supple shock. For example, fears of supply disruptions caused by this fall's hurricanes sent the price of oil to around $70 per barrel. Even after hurricanes Katrina and Rita have passed, the price of oil remains well above $60 per barrel. It has been predicted that some developed economies, such as Japan, Germany, and Italy, could slip into recession if the price of oil swells to $80 per barrel. This risk occurs because these countries' economies are not on as solid ground as the U.S. and Chinese economies. For example, economic growth in the Eurozone remains weak. Second quarter growth came in at 1.2%, and third-quarter indicators have been promising. However, the sustainability of the European expansion is a concern. Europe's recent growth is a double-edge sword. While growth is a positive, it also reduces the odds the European Central Bank will soon lower interest rates. Another concern is sluggish consumer spending in Europe. In the U.S., higher energy prices, higher energy volumes, and higher raw material costs will raise the nation's import bill. As a result, trade deficit swells to $788.4 billion in 2006. The trade deficit eventually shrinks. But this retreat is slow, so that the trade deficit is about $670 billion by 2008. The stubborn trade deficit will continue to put downward pressure on the dollar. Specifically, the greenback's value versus the currencies of the nation's major trading partners should slide 2.9% in 2005, 4.9% in 2006, 5.3% in 2007, and 0.5% in 2008.

Employment: The U.S. employment situation remains encouraging. Recent data show U.S. nonfarm employment grew strongly this summer and Hurricane Katrina's impact on nonfarm employment was much lower than had been anticipated. Although the storm made landfall in late August, its employment impact was not measured in that month. The official employment count is for the week on which the 12th day of the month falls. Hurricane Katrina hit in late August after that month's employment had already been tabulated. The employment impacts were included in the September 2005 numbers instead. The September report showed the impact was less severe than had been feared. This forecast assumed Hurricane Katrina's employment toll would be 270,000 jobs in September. About 18,000 Boeing machinists went on strike on September 2, 2005. Based on the length of previous strikes, it is assumed this strike will last 60 days. Combined, it was calculated the Boeing machinist strike and Katrina would cause roughly 290,000 jobs to disappear in September. Of course, some of this decline would be offset by job gains in other parts of the economy. It was assumed 170,000 other jobs would be created, so the net effect would be 120,000 jobs lost in September. The U.S. Department of Labor estimates the net job loss for the month was much smaller than had been assumed; it was around 35,000. Part of this net job impact reflects the nation's strong employment situation. For example, the U.S. Department of Labor initially reported U.S. nonfarm employment advanced by 169,000 jobs in August. While this was below the year-to-date monthly average of 194,000, it was still a respectable showing. However, the August gain has been revised to 211,000. The Department of Labor also increased its July nonfarm employment estimate to 277,000. The labor market's strength this summer is also visible in the falling U.S. civilian unemployment rate that sank to a recovery low of 4.9%, its lowest level in four years. The improvements stopped in September when the unemployment rate rose to 5.1%. The unemployment rate is expected to stay near this level for the remainder of this year, then, boosted by rebuilding efforts, gradually decline. Ironically, the low unemployment rate is a symptom of one of the challenges of rebuilding the areas impacted by Hurricane Katrina. The red-hot housing market has virtually sopped up all of the nation's construction talent. As a result, the region may find itself trying to tap into a labor market that is already drained.

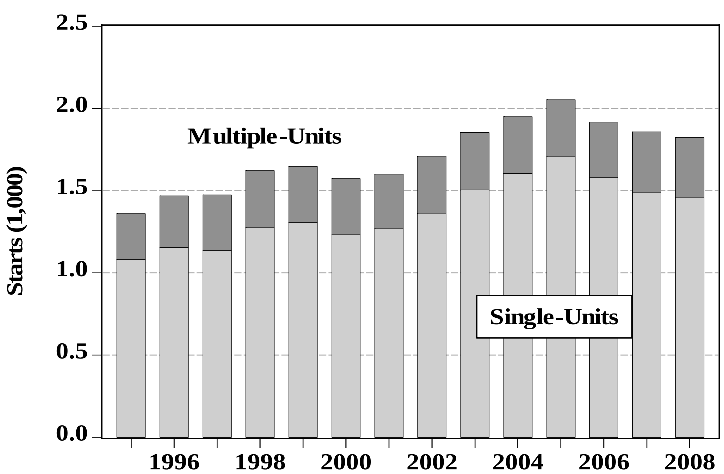
U.S. Civilian Unemployment Rate



Source: Global Insight

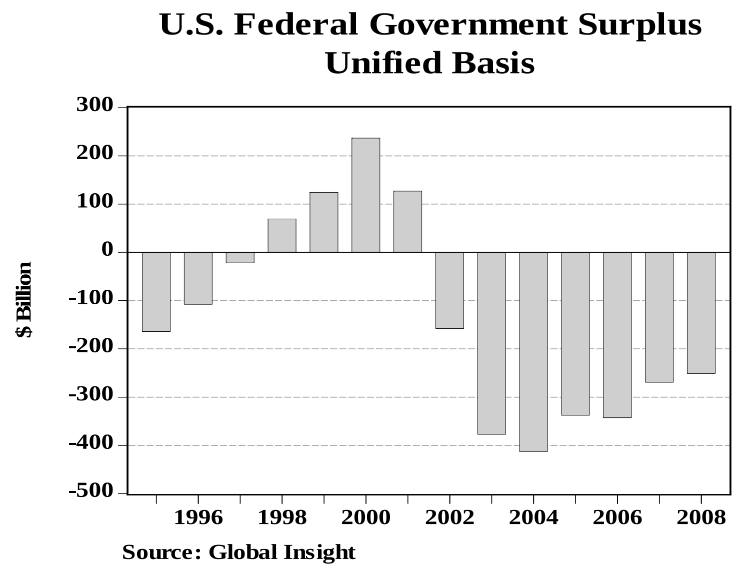
Housing: Hurricane Katrina will influence the U.S. housing market over the next three to four years. The primary impact of the hurricane will be to slow the reversion of housing starts toward demographic norms, which will buffer any drag from the housing sector on national output. While it is still too early to determine with any certainty the storm's damage, this forecast assumes 150,000 housing units were destroyed. In addition, an even larger number of homes were damaged and will require substantial repairs. Replacements and adjustments will take time and come in waves. The first wave will be a fleet of mobile homes for displaced persons and some easy repairs to homes with minor damage. The second wave will be repairs to more damaged homes outside New Orleans. In New Orleans, damages will take

U.S. Housing Starts



Source: Global Insight

longer to assess and repair, since all aspects of construction have been disrupted. Inspectors need to evaluate damage and grant permits, materials must be marshaled, and construction workers are needed. The major push to rebuild will not take place until after the flood waters are drained. National housing starts are forecasted at 2.05 million units in 2005, 1.91 million units in 2006, 1.86 million units in 2007, and 1.82 million units in 2008. These totals are, respectively, 19,000, 56,000, 71,000, and 54,000 above Global Insight's August 2005 forecast.



Government: The projected high costs of hurricane relief and reconstruction are modifying the timetables for a couple of federal government policy issues. First, the aggressive deficit-reduction path articulated by the administration faces a detour in 2006 due to the large, expected jump in federal transfer payments to individuals, federal grants-in-aid to the states, and disbursements under the National Flood Insurance Program. Second, tax reform proposals, which have been spearheaded by the President's Advisory Commission on Tax Reform, will likely be put on the back burner until late 2005 or early 2006. The current forecast assumes the federal government's response to hurricane relief increases federal outlays by $100 billion spread over several years. This total includes $70 billion in spending by FEMA (which includes $10 billion for flood insurance) and $30 billion to pay for public infrastructure. The increased federal outlays boost the federal deficit to $338 billion in fiscal year 2005 and to $343 billion in fiscal year 2006. Interestingly, the stronger economic growth in the next few years lowers the federal budget deficit to about $208 billion in fiscal year 2010, which is actually lower than in the August 2005 forecast.